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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

October 30, 1997

Mr. William F. Caton, Acting Secretary
Federal Communications Commission
1919 M Street, NW Room 222
Washington, DC 20554

EX PARTE OR LATE FILED

Re: Ex Parte Presentation:

In the Matters of American Communications Services, Inc.'s Petition for Declaratory Ruling Regarding Preemption of the Arkansas Telecommunications Regulatory Reform Act of 1997 and MCI Telecommunications Corporations' Petition for Expedited Declaratory Ruling Regarding Preemption of the Arkansas Telecommunications Regulatory Reform Act of 1997, CC Docket No. 97-100

Dear Mr. Caton:

Please file the attached document as part of the record in the above captioned proceeding. The document contains answers to questions proposed by staff in advance of MCI's October 3, 1997 meeting.

Two copies of this Notice are being submitted to the Secretary of the FCC in accordance with Section 1.1206(a)(1) of the Commission's rules.

Sincerely,

Kimberly M. Kirby

Kimberly M. Kirby

Attachment

cc: Melissa Newman (CCB)
Alex Starr (CCB)
Jonathan Askin (CCB)
Jonady Hom (CCB)

No. of Copies rec'd 0+2
List ABCDE

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MCI Ex Parte
CC Docket No. 97-100
Answers To Staff Questions 7-8, 9
October 30, 1997

Universal Service Questions

Section 254 of the Act provides that the Commission shall establish rules relating to universal service after considering recommendations prepared by the Federal-State Joint Board on Universal Service. § 254(a). In setting rules, the Commission is directed to consider certain principles, §254(b)(1)-(6), and to establish any other principles the Commission deems necessary and appropriate. §254(b)(7). Section 254 allows states to adopt regulations relating to their own universal service funds, but provides that such state regulation cannot be inconsistent with the Commission's rules. § 254(f).

The Commission issued Universal Service rules on May 8, 1997. See In the Matter of Federal-State Joint Board on Universal Service, Report and Order, CC Docket No. 96-45 (rel. May 8, 1997) (Universal Service Order). In that Order, the Commission adopted several principles that are directly relevant to this petition. First, the Commission adopted the principle of competitive neutrality. See Universal Service Order at ¶ 47. The Commission found that "[u]niversal support mechanisms and rules should be competitive neutral," and that "competitive neutrality means that universal support mechanisms and rules neither unfairly advantage nor disadvantage one provider over another . . ." Id. The Commission also determined that the "proper measure of cost for determining the level of universal service support is . . . forward-looking economic cost . . ." Id. at ¶ 224. In adopting this forward-looking cost methodology, the Commission expressly rejected the assertion made by certain ILECs that "embedded costs" should be considering in calculating the rate of support. Id. at ¶ 227.

As noted above, § 254(f) makes clear that state legislatures may adopt regulations that govern their own universal service funds, but also makes clear that these regulations may not be inconsistent with the rules adopted by the Commission. Thus, any state regulation that conflicts with the requirements of competitive neutrality and funding based on forward-looking costs established by the Commission cannot stand, and must be preempted.

Question 7: Describe with particularity the bases for your contention that section 4(e)(4)(A) conflicts with the Federal Telecommunications Act?

A. How is section 4(e)(4)(A) inconsistent with the Commission's rules?

B. How does 4(e)(4)(A) create a barrier to entry?

C. How does 4(e)(4)(A) rely on or burden Federal universal service support mechanisms?

Answer:

Section 4(e)(4)(A) of the Arkansas Act is a "make-whole" provision for Arkansas' ILEC. This provision provides that any decrease in the incumbent LEC's federal universal service funding will be made up by a corresponding rate increase or draw from the state universal service fund (the AUSF). This additional draw from the state fund is only available to the incumbent local exchange carrier. No new entrant can receive this additional funding. This provision, on its face, violates the principle of competitive neutrality.[1] Because it flatly conflicts

[1] Section 4(A)(4)(B) creates a similar "make-whole" provision for any reduction in the ILECs' access revenue.

with the Commission's rules, this provision of the Arkansas Act should be preempted.[2]

Section 4(e)(4)(A) is also subject to preemption under § 253. This provision puts new competitors at a significant and insurmountable disadvantage to their incumbent counterparts serving high cost areas. New entrants considering entering a high-cost local market will be faced with the prospect of competing with an incumbent who will always receive higher universal service funding. A new competitor cannot, of course, price its services higher than the incumbent and hope to gain any market share whatsoever. If the new entrant prices its local service at the same level as the incumbent, however, it will realize less revenue and less profit because the universal service funding it receives for serving that customer will always be lower. This obviously creates a situation in which, because of the Arkansas regulatory regime, new entrants will not attempt to compete in high cost markets. Because section 4(a)(4)(A) thus creates a barrier to entry, it should be preempted under §253 as well.[3]

Although MCI believes that, depending on how it is eventually constituted, the Arkansas Act could "rely on or burden" the federal fund in contravention of the Federal Act, it is

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[2] This discrepancy is exacerbated by the Arkansas Act's requirements that high cost funding shall be based on embedded cost. § 4(a)(5). Because rates based on embedded cost will be higher than those based on forward-looking cost, and because only ILECs have "embedded" costs, the Arkansas Act further inflates the difference between the rate at which the ILEC will recover and the rate at which new entrants will recover. Because this requirement also directly conflicts with the Commission's rules, it should also be preempted.

[3] In the Universal Service Order, the Commission recognized that rules which are not competitively neutral can "restrict[] the entry of potential service providers." Universal Service Order at ¶ 48.

not basing its preemption claim on that clause.

Question 8:

Given that the FCC has concluded that "section 214(e) does not prohibit a state from establishing criteria for designation of eligible carriers in connection with the operation of that state's universal service mechanism, consistent with section 254(f)" (Universal Service Order at ¶ 136), describe with particularity the bases for your contention that section 5(b)(3) conflicts with 47 U.S.C. § 214(e)?

Answer:

Although state commissions can establish additional criteria for designation of eligible carriers in connection with their own universal service funds, as the Commission has recognized they can only do so in accordance with section 254(f), which prevents any state universal service regulation that is inconsistent with the Commission's rules. See Universal Service Order at ¶ 136. Section 5(b)(3) of the Arkansas conflicts with the Commission's requirement of competitive neutrality, and must be preempted.

As noted above, a rule is not competitively neutral if it "unfairly advantage nor disadvantage one provider over another . . ." Universal Service Order at ¶ 47. Section 5(b)(3) allows for competitors to be eligible for funding in high-cost areas, but prohibits them from receiving funding that is higher than that received by the incumbent. Thus, if an efficient competitor entered a high-cost market in competition with the incumbent LEC, the Arkansas Act prohibits it from receiving more AUSF funding than that received by the ILEC, even if the competitor serves more customers than does the ILEC. In essence, section 5(b)(3) insures that the incumbent LEC will always receive at least as much state universal service funding as its competitors, no matter how many or few customers the incumbent serves. This rule cannot withstand even cursory scrutiny; it blatantly seeks to protect the incumbent against potential competitors. Because it is not competitively neutral it flatly conflicts with the Commission's rules and should be preempted.[4]

For much the same reasons set out above, this section also violates § 253, and could be preempted on those grounds as well. Any statute which expressly seeks to protect an incumbent against competitive entry clearly poses a barrier to entry in violation of the 1996 Act. Because that is exactly what §5(b)(3) does, it is preemptable on those grounds as well.

Question 9:

What limitations does the Federal Telecommunications Act impose on state legislatures to create their own universal service funding mechanism?

Answer:

State legislatures can impose additional requirements or establish additional principles in creating their own universal service funding mechanisms, as long as those requirements or principles are not inconsistent with the Commission's rules. § 254(f); see also Universal Service Order at ¶ 135. These requirements must be competitively neutral, and cannot, therefore, affect competitors differently than they do incumbents. See id. at ¶ 47; id. at ¶ 49 (finding that competitively neutral rules are needed to ensure that "no entity receives an unfair competitive advantage that may skew the marketplace or inhibit competition by limiting the

[4] The balance of 5(b) suffers from the same infirmity, and should be preempted as well.

available quantity of services or restricting the entry of potential service providers"). Thus, requirements that apply to all carriers equally -- and which therefore are competitively neutral -- and which do not conflict with other Commission's rules, can be imposed by the states.

OTHER

In our most recent submission, in response to question 5 (filed October 29, 1997), we indicated that we have been unable to ascertain the results of the AT&T arbitration in Arkansas. We have since learned that the wholesale discount rate set by the Arkansas commission in that arbitration was 14.5 % (per cent). This is significantly lower than the Commission's proxy wholesale discount rate range of 17-25%, set forth in the FCC's Interconnection Order. Because the wholesale discount calculation mandated by the Arkansas Act necessarily results in wholesale discount rates that are lower than the Telecommunications Act requires, it is not at all surprising that the discount rate set in Arkansas is so low.